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**Statement of
Position**

80-3

**Accounting for Real Estate
Acquisition, Development,
and Construction Costs**

December 22, 1980

**Proposal to the
Financial Accounting Standards Board**

**Issued by
Accounting Standards Division**

**American Institute of
Certified Public Accountants**

AICPA

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NOTE

Statements of position of the accounting standards division are issued for the general information of those interested in the subject. They present the conclusions of at least a majority of the accounting standards executive committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting and cost accounting.

The objective of statements of position is to influence the development of accounting and reporting standards in directions the division believes are in the public interest. It is intended that they should be considered, as deemed appropriate, by bodies having authority to issue pronouncements on the subject. However, statements of position do not establish standards enforceable under the Institute's code of professional ethics.

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Accounting for Real Estate Acquisition, Development, and Construction Costs

Introduction

1. Recent trends in real estate development activities have dramatically increased the size of enterprises engaged in real estate development, the cost of individual projects, and the time required to complete the development of individual projects. Those trends have focused attention on the need for guidance in accounting for costs associated with real estate acquisition, development, and construction. The accounting standards division of the American Institute of Certified Public Accountants has prepared this statement of position in response to that need.

Scope of the Statement

2. Except as indicated in paragraph 3, the recommendations in this statement apply to accounting for real estate acquisition, development, and construction costs in financial statements that are intended to present financial position, results of operations, or changes in financial position in conformity with generally accepted accounting principles, regardless of the nature of the entity involved. The division believes that, in providing guidance, it is desirable to reduce, to the extent practicable, alternative practices in accounting for costs of real estate acquisition, development, and construction.

3. This statement does not apply to
- a. Real estate developed by an enterprise for use in its own operations (excluding sale or rental). In this context, “real estate developed by an enterprise for use in its own operation” includes real estate developed by a member of a consolidated group for use in the operations of another member of the group (for example, a manufacturing facility developed by a subsidiary for use in its parent’s operations) when the property is reported

in the group's consolidated financial statements. However, such property is not "real estate developed for use in the enterprise's operations" when reported in the separate financial statements of the entity that developed it.

- b. Retail lots sold on a volume basis with down payments that are less than those required to evaluate the collectibility of casual real estate sales. The AICPA industry accounting guide, *Accounting for Retail Land Sales*, applies to accounting for lots sold on that basis.
- c. Costs and operations covered by the AICPA statement of position, *Accounting for Costs to Sell and Rent, and Initial Rental Operations of, Real Estate Projects*.

4. Because of the nature of the issues discussed in this statement, and because of the variety of enterprises whose transactions are covered by this statement, the division emphasizes that the provisions of this statement, like the provisions of all statements on accounting principles, need not be applied to items that would have an immaterial effect on an enterprise's financial position or results of operations; also, methods other than those recommended may be used if their use yields results not materially different from the results of applying the recommended methods.

Definitions

5. For purposes of this statement, the following terms are defined:

- a. *Common costs*. Costs that relate to two or more units within a real estate project and thus require allocation to determine the cost of project subdivisions. For example, land cost is usually common to the entire project and must be allocated to phases, tracts, releases, and, ultimately, individual units to determine the cost of sales or the cost of individual units of investment property. Other common costs may relate only to a phase, a tract, or a release and would be allocated only to the parcels to which they relate.
- b. *Fair value*. The amount in cash or cash equivalent value of other consideration that a real estate parcel would yield in a current sale between a willing buyer and a willing seller, that is, other

than in a forced or liquidation sale. The fair value of a parcel is affected by its physical characteristics, its probable ultimate use, and the time required for the buyer to make use of the property, considering access, development plans, zoning restrictions, and market absorption factors. *Relative fair value* is the fair value of each parcel in a real estate project in relation to the fair value of the other parcels in the project. *Relative fair value before construction* is the fair value of each land parcel in a real estate project in relation to the fair value of the other parcels in the project, exclusive of value added by on-site development and construction activities.

- c. *Incidental operations.* Minor revenue-producing activities engaged in during the holding or development period to reduce the cost of developing the property for its intended use, as distinguished from activities designed to generate a profit or a return from the use of the property.
- d. *Incremental revenues and costs of incidental operations.* Revenues that would not be produced, or costs that would not be incurred, except in relation to the conduct of incidental operations. Costs that are not incremental are interest, taxes, insurance, security, and similar costs that would be incurred during the development of a real estate project regardless of whether incidental operations were conducted.

Nature of Real Estate Acquisition, Development, and Construction Activities

6. Real estate acquisition, development, and construction activities occur in four stages: (a) predevelopment, (b) development, (c) construction, and (d) sales or rental operations. Distinguishing between different stages, or distinguishing the beginning and end of some stages, may often be difficult because similar costs may be incurred in different stages.

7. During the predevelopment stage, the purchaser investigates the property, negotiates for its acquisition, and finally enters into a formal contract to acquire the property. In addition to the agreed consideration, the purchaser incurs costs for related legal, recording, and title services. Costs also may be incurred for such activities as appraisals, market feasibility studies, architectural and engineering services, soil tests, and zoning changes. Some of those

costs may be incurred before there is a formal commitment to acquire the property.

8. Real estate builders and developers may acquire property well in advance of the beginning of construction and hold the property for an extended period while preparing development and building plans and obtaining zoning changes and other required permits. During that period, costs are incurred for those activities and for such items as interest and property taxes.

9. On-site and off-site improvements, such as roads, sewers, utilities, grading, and site clearance, are made before the construction stage. Zoning approvals and building permits may require the developer to set aside land for community facilities (such as schools, parks, and roads) to be donated to local authorities or governmental units. Developers may be required to contribute funds to governmental units to help finance the construction of facilities, such as sewer plants and schools, to serve the property.

10. Real estate developers may receive revenue from, and incur costs for, incidental operations relating to real estate, such as the operation of temporary parking lot facilities or the leasing of undeveloped land for grazing or farming.

11. Real estate projects may include amenities, such as golf courses, tennis courts, indoor recreational facilities, parking facilities, and utility plants. Some amenities are sold to tenants' or homeowners' associations; others are intended to be self-supporting enterprises. Some or all of the costs of other amenities are expected to be recovered from lease or sale.

12. Differentiating between costs to be charged to expense and costs to be capitalized and associating capitalized costs with particular assets pose complex problems in accounting for real estate projects. Real estate projects generally require several accounting periods to complete. In addition, large real estate projects usually involve multiple purchases and sales that require complex cost accumulation and allocation techniques. Development and construction plans and costs and revenues are affected by such factors as market conditions, inflation, interest rates, zoning restrictions, terrain, and location. For example, a residence next to a golf course or an office near the top of an office tower usually generates more revenue than a similar unit otherwise situated.

Present Accounting Practices

Cost Capitalization

13. Except for the general practice of capitalizing direct acquisition, development, and construction costs, cost capitalization practices vary widely. Some entities capitalize property-related costs incurred before the acquisition of the property and include them in the cost of the property when it is acquired. Some entities capitalize as property costs expenditures during the development and construction phases for interest, taxes, insurance, and indirect project costs (indirect costs related to project development and construction). Others capitalize only some or none of those costs. An entity may have different capitalization practices for different projects or for different components of a particular project.

14. Accounting for revenues and expenses of amenities and incidental operations also varies. Some enterprises account for such revenues and expenses as decreases or increases in capitalized project costs, and others include them in current operating results.

Allocation of Capitalized Costs

15. Real estate developers generally use one or more, including a combination, of the following methods to allocate capitalized costs: area, value, and specific identification. Under area methods, common costs are allocated to individual units based on the number of units or size, such as acreage or square footage. Under value methods, costs are allocated to individual units based on the relative value of the individual units. Under specific identification methods, costs identified with a specific property are assigned to that property. Common costs associated with the entire development, such as access roads, utility trunk lines, and amenities, usually are allocated by area and value methods.

The Division's Conclusions

16. As a general rule, costs clearly associated with the acquisition, development, and construction of a real estate project should be capitalized. The division believes, however, that the recommendations in this statement should be applied to the following: (a) preacquisition costs, (b) interest, taxes, and insurance, (c) indirect project costs, (d) amenities, (e) incidental operations, (f) allocation of

capitalized costs to components of a real estate project, (g) revisions of estimates, (h) costs in excess of estimated net realizable value, (i) abandonments and changes in use, and (j) cost of sales.

Preacquisition Costs

17. Payments to obtain an option should be capitalized as incurred. Other costs related to a property that are incurred before the enterprise acquires the property, or before the enterprise obtains an option to acquire it, should be deferred, provided all three of the following conditions are met:

- a. The costs are directly identifiable with the specific property.
- b. The costs would be capitalized if the property were already acquired.
- c. Acquisition of the property or of an option to acquire the property is probable.¹ For this condition to be met, the prospective purchaser must be actively seeking to acquire the property and must have the ability to finance or obtain financing for the acquisition under circumstances in which there is no evidence indicating that the property is not available for sale.

If any one of these three conditions is not met, costs incurred before a property is acquired should be charged to expense as incurred.

18. Option costs and the accumulated amount of deferred preacquisition costs (a) should be capitalized as project costs on acquisition of the property or (b) to the extent not recoverable by sale of the options, plans, and so forth, should be charged to expense when it is probable that the property will not be acquired. The amount of option costs and deferred preacquisition costs should be disclosed in the financial statements.

Interest, Taxes, and Insurance

19. Statement of Financial Accounting Standards 34, *Capitalization of Interest Cost*, prescribes the accounting for interest cost. Costs incurred on real estate for property taxes, insurance, and similar items should be capitalized as property cost only during

¹*Probable* is defined for accounting purposes in Statement of Financial Accounting Standards 5 as "likely to occur" and is used in the same sense in this statement.

periods in which activities necessary to get the property ready for its intended use are in progress. Costs incurred for such items after the property is substantially complete and ready for its intended use should be charged to expense as incurred.

Indirect Project Costs

20. *Indirect project costs* are indirect costs incurred after the acquisition of the property, such as construction administration, legal fees, and various office costs (cost accounting, design, and other departments providing services to projects), that clearly relate to projects under development or construction. Some indirect project costs clearly relate to a specific project, such as costs associated with a field office at a project site and the administrative personnel that staff the office, and they should be capitalized as a cost of that project. Other indirect project costs may relate to several projects and should be capitalized and allocated to the projects to which the costs relate in a rational manner based on the nature of activity that gave rise to the costs. To illustrate, 60 percent of a construction administration department's time is spent managing internal projects under current development, 35 percent is spent managing projects for others for a fee, and 5 percent is spent administering the maintenance of operating properties; 60 percent of the costs should be capitalized and allocated to the project, and 40 percent should be charged to expense as incurred.

21. Indirect costs that do not clearly relate to projects under development or construction and all general and administrative costs should be charged to expense as incurred.² General and administrative costs include such costs as entity management salaries, general accounting, corporate office expense, general legal services, and similar costs of the type generally incurred by all enterprises for the conduct of business.

Amenities

22. Accounting for costs of amenities, such as golf courses, utility plants, clubhouses, swimming pools, and tennis courts, should be based on management's plans for the amenities in accordance with the following:

²Costs to sell and rent real estate projects should be accounted for in accordance with AICPA Statement of Position 78-3, *Accounting for Costs to Sell and Rent, and Initial Rental Operations of, Real Estate Projects*.

- a. If an amenity is to be sold or transferred in connection with the sale of individual units, costs (including expected future operating costs to be borne by the developer until they are assumed by buyers of units in a project) in excess of anticipated proceeds should be allocated as common costs since the amenity is clearly associated with the development and sale of the project.
- b. If an amenity is to be sold separately or retained by the developer, capitalizable cost of the amenity in excess of its estimated fair value, as of the expected date of its substantial physical completion, should be allocated as common costs.³ For the purpose of determining the amount to be capitalized as common costs, the amount of cost allocated to the amenity should not be revised after it is substantially completed and available for use. A later sale of the amenity at more or less than its estimated fair value as of the date of substantial physical completion, less any accumulated depreciation, gives rise to a gain or loss that should be included in net income in the period in which the sale occurs.

As indicated in paragraph 26 of this statement, common costs should be allocated on the basis of relative fair value (before construction) of each land parcel benefitted. In allocating costs of amenities as common costs, land parcels benefitted should be limited to those for which development can reasonably be expected.

23. Before an amenity is substantially completed and available for use, operating results of the amenity should be included as a reduction of, or addition to, common costs. When an amenity to be sold separately or held for investment is substantially completed and available for use, current operating income and expenses of the amenity should be included in current operating results, since the operations of the amenity no longer clearly relate to the development and sale of the project as a whole but, rather, relate to the objective of making a profit on operations or sale of the amenity itself or of using the amenity as a sales promotional tool.

24. The following assumed data are used to illustrate the application of the recommended accounting for the costs of amenities:

³The accounting for costs of amenities to be sold separately or retained by the developer recommended in this statement differs from the accounting for costs of such amenities under the AICPA industry accounting guide, *Accounting for Retail Land Sales*, because of differences in circumstances. This statement does not apply to transactions to which that guide applies.

- a. A single family residential project is to include a recreation center, consisting of a swimming pool and tennis courts, with an estimated cost of \$250,000.
- b. The center is to be transferred to a homeowners' association in connection with the sale of the units in the project.
- c. Each purchaser of a unit will be obligated to pay a monthly assessment fee.
- d. The developer agrees to pay net operating costs before the expected date of transfer and the monthly assessment fees for all unsold units. Such support is estimated to cost \$50,000.

Based on these assumptions, the total estimated cost of \$300,000 (the \$250,000 cost of the center plus \$50,000 in support costs to be paid by the developer) should be allocated as common costs based on the relative fair value of each lot benefitted. The accounting would differ, however, if the assumptions were modified as follows:

- a. The center is to be retained by the developer.
- b. Net operating costs are estimated to be \$30,000 before substantial physical completion and \$20,000 after substantial physical completion.
- c. The fair value of the center at the date of substantial physical completion is estimated to be \$200,000.

Under the modified assumptions, \$80,000, the amount by which the costs of the center plus the estimated net operating costs before substantial completion (\$250,000 plus \$30,000) exceed the estimated fair value at the date of substantial physical completion (\$200,000), should be allocated as common costs. Actual operating losses incurred after substantial physical completion should be included in current operating results.

Incidental Operations

25. An excess of incremental revenue over the incremental costs of incidental operations, such as the operation of temporary parking lot facilities or the leasing of undeveloped land for grazing or farming, should be accounted for as a reduction of capitalized project costs. An excess of incremental costs over incremental revenue should be charged to expense as incurred, since it did not achieve

the objective of reducing the cost of developing the property for its intended use.

Allocation of Capitalized Costs to the Components of a Real Estate Project

26. To the extent that this is practicable, the costs of acquisition, development, and construction of real estate projects should be capitalized and assigned to individual components of the project on the basis of specific identification. Land cost and all other common costs should be allocated on the basis of the relative fair value (before construction) at the date of allocation to each land parcel benefited.⁴ The division believes that allocation on the basis of relative fair value is consistent with the generally accepted principle for allocating joint costs to separable outputs and assigns joint costs to individual parcels, phases, and units on the basis of their potential revenue contributions.

27. A land parcel may be considered to be an individual lot or a "phase," defined for this purpose as a parcel on which units are to be constructed concurrently. It may be necessary to accumulate costs in one or more cost centers before final allocation if some costs apply to different portions of a project, for example, if some costs apply only to certain components of a project and other costs apply to other components or to the entire project.

28. Construction costs should be assigned to the individual units in a phase on the basis of specific identification, if practicable. Otherwise, construction costs applicable to the phase should be allocated to individual units in the phase in a reasonable manner that achieves results comparable to allocation on the basis of the relative sales value of the individual units to the sales value of the total units in the phase.

29. For the purpose of illustrating the general principles, a developer is assumed to have under development a single-family residential subdivision for which assigning costs to individual units by specific identification is impracticable. The smallest practicable

⁴The AICPA industry accounting guide, *Accounting for Retail Land Sales*, permits the use of other methods of allocating common costs (for example, the area method) that fairly match costs with related revenues. This statement does not apply to transactions to which that guide applies.

unit for that purpose is a group of units to be constructed as a separate phase and sold individually. Based on those assumptions, the cost allocations might be as follows:

- a. On-site and off-site costs specifically identified with the units in the phase would be allocated to the phase.
- b. Common costs of the entire project (or a parcel) of which the phase is a part would be allocated to the phase on the basis of the relative fair value of the land in the phase (before construction) to that of the project (or parcel).
- c. Costs allocated to the phase would be allocated to an individual unit on the basis of the relative sales value of the unit to that of all units in the phase. If a phase includes both units to be sold and units to be held for investment, the final allocation would be made to the investment units on the basis of the relative fair value of the investment units to the total of the sales value of the units to be sold and the fair value of the investment units.

This illustration applies only to costs for which assignment to individual units on the basis of specific identification is not practicable. To the extent that it is practicable, all costs should be assigned to individual units on the basis of specific identification.

Revisions of Estimates

30. Estimates and cost allocations should be reviewed at the end of each financial reporting period until a project is substantially completed and available for sale. Costs should be revised and reallocated as necessary for material changes on the basis of current estimates. Changes in estimates should be accounted for in accordance with paragraph 31 of APB Opinion 20, *Accounting Changes*, which states

The effect of a change in accounting estimate should be accounted for in (a) the period of change if the change affects that period only or (b) the period of change and future periods if the change affects both. A change in an estimate should not be accounted for by restating amounts reported in financial statements of prior periods or by reporting pro forma amounts for prior periods.

Most revisions of estimates relating to real estate cost allocations affect both the period of the change and future periods, and their effects should therefore be accounted for prospectively in the period

of the change and future periods. For example, an increase in the estimate of the common costs of a project should be allocated to current and future periods even though the allocation results in lower profit margins on current and future sales than on prior sales from the project. However, increases in costs without comparable increases in market value can raise questions about whether the estimated total cost of property not yet sold exceeds its net realizable value.⁵

31. When an enterprise records sales of real estate and records in cost of sales accruals for estimated costs to be incurred (which may include a portion of estimated common costs allocable to the property sold—see paragraph 35 of this statement), changes in estimates of those costs should be recorded in cost of sales in the period in which the differences become known, since they are unrelated to future operating results.⁶ To illustrate, the following circumstances are assumed: (a) sales of property were recorded in full in prior periods and did not require any deferral of revenue for future performance and (b) estimated costs of \$200,000 have been accrued relating to the sales revenue previously recorded. If current estimates of such costs are \$250,000, an additional \$50,000 should be accrued and charged to cost of sales in the current period.

Cost in Excess of Estimated Net Realizable Value

32. Capitalization of costs associated with the development and construction of a property should not cease when present accounting principles require recognition of a lower value for the asset than

⁵In accounting for sales of real estate in circumstances in which the seller has an obligation of future performance to complete improvements and amenities of a project, the seller may be required to record a portion of the sales price as deferred revenue based on the ratio of the estimated cost of the future performance to total cost. (See the AICPA industry accounting guide, *Accounting for Profit Recognition on Sales of Real Estate*.) Revisions of estimated costs to complete project improvements and amenities may relate to previously recorded deferred revenue. In those cases, the relationship of the two elements comprising the deferred revenue—costs and profit—should be recalculated to determine the amount of the deferred revenue to be recognized as the costs are incurred. However, if the revised estimated cost of future performance exceeds the remaining applicable deferred revenue, the excess should not be deferred but, rather, should be charged to income immediately.

⁶If, in accordance with paragraphs 47 through 50 of the AICPA industry accounting guide, *Accounting for Profit Recognition on Sales of Real Estate*, all or a portion of the revenue for a sales transaction is deferred because the seller has an obligation for future performance, the costs related to the revenue should be recognized when the sales revenue is recognized.

acquisition cost.⁷ When the capitalized cost of real estate held for sale or for development and sale exceeds its estimated net realizable value, an allowance should be provided to reduce the carrying amount to estimated net realizable value, determined on the basis of an evaluation of individual projects. An individual project, for this purpose, consists of components that are relatively homogeneous, integral parts of a whole (for example, individual houses in a residential tract, individual units in a condominium complex, and individual lots in a lot subdivision). Therefore, a multiphase development consisting of a tract of single-family houses, a condominium complex, and a lot subdivision generally would be evaluated as three separate projects.

Abandonments and Changes in Use

33. Real estate, including rights to real estate, may be abandoned, for example, by allowing a mortgage to be foreclosed or by allowing a purchase option to lapse. Capitalized costs, including allocated common costs, of real estate abandoned should be written off as current expenses or, if appropriate, to allowances previously established for that purpose and should not be allocated to other components of the project or to other projects, even if other components or other projects are capable of absorbing the losses. Donations of land to municipalities or other governmental agencies for uses that will benefit the project are not abandonments. The cost of the land donated should be allocated as a common cost of the project.

34. Changes in the use of real estate comprising a project or a portion of a project may arise after significant development or construction costs have been incurred. In such circumstances, development and construction costs incurred before the change should be written off, except as follows:

- a. If the change is made pursuant to a formal plan for a project that is expected to produce a higher economic yield, the write-off may be limited to the amount by which the capitalized costs

⁷For real estate held for sale or development and sale, the lower value to be recognized is net realizable value (NRV). NRV is the estimated selling price in the ordinary course of business less estimated costs of completion (to the stage of completion assumed in determining selling price), holding, and disposal.

incurred and to be incurred exceed the estimated value of the revised project at the date of substantial physical completion.

- b. In the absence of a formal plan for a project that is expected to produce a higher economic yield, the write-off may be limited to the amount by which total capitalized costs exceed the estimated net realizable value of the property, determined on the assumption that it will be sold in its present state.

To illustrate, the total capitalized costs of a golf course are assumed to be \$1 million, including development and construction costs of \$700,000 and land costs of \$300,000. If, pursuant to a formal plan, the golf course is to be torn up in order to build single-family residences for sale, and such use would recover the capitalized costs of the golf course as well as the construction and development costs of the new project, the \$1 million may be included in the cost of the new project. If, on the other hand, golf course operations are terminated by reason of continuing operating losses without a formal plan for a project expected to produce a higher economic yield, the \$700,000 of development and construction costs should be written off to the extent that the total unrecovered costs of \$1 million exceed the estimated net realizable value of the property in its present state.

Cost of Sales

35. Costs applicable to real estate should be charged to cost of sales when the related sales revenue is recorded in operating results.⁸ Such costs include the allocated portion of costs incurred plus accruals (including revisions—see paragraph 31) for estimated costs to be incurred for the real estate sold.

Transition

36. The accounting standards division recommends the application of the provisions of this statement prospectively for fiscal years, and interim periods in those fiscal years, beginning after December 24, 1980. Earlier application is encouraged for fiscal years beginning before December 25, 1980, for which financial statements have not been issued. Costs capitalized or deferred in accordance with gen-

⁸For a discussion of circumstances under which recognition of revenue is deferred because of the seller's obligation for future performance, see note 6.

erally accepted accounting principles in years before the fiscal year for which the provisions of this statement are first applied should not be written off, even though such costs do not qualify for capitalization or deferral according to the conclusions in this statement. Such capitalized costs should be reallocated to components of real estate projects in accordance with the conclusions in this statement unless it is not practicable to do so. Changes in estimates and reallocations made to conform with the conclusions in this statement should be accounted for as revisions of estimates, as discussed in paragraphs 30 and 31 of this statement. Costs charged to expense in years before the fiscal year for which the provisions of this statement are first applied should not be capitalized or deferred to conform to the conclusions in this statement.

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